

COMMONWEALTH OF MASSACHUSETTS
DEPARTMENT OF TELECOMMUNICATIONS AND ENERGY

Investigation by the Department of Public Utilities on its own motion
into IntraLATA and Local Exchange Competition in Massachusetts

D.P.U./D.T.E. 94-
185-E

**REPLY BRIEF OF AT&T COMMUNICATIONS OF NEW ENGLAND, INC.
REGARDING PRICE FLOORS**

Jeffrey F. Jones

Jay E. Gruber

Palmer & Dodge llp

One Beacon Street

Boston, MA 02108

(617) 573-0100

Robert Aurigema

AT&T Communications, Inc.

32 Avenue of the Americas, Room 2700

New York, NY 10013

(212) 387-5627

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Introduction.

AT&T Communications of New England, Inc. ("AT&T") submits this reply brief to respond to certain mischaracterizations and fallacious arguments that Bell Atlantic put forward in its initial brief regarding price floors. Because this reply brief addresses a number of discrete points, it makes no attempt to reiterate the arguments set forth in AT&T's initial brief.

I. Bell Atlantic Should Not Be Allowed To Combine Its Toll And Non-toll Services For Purposes Of A Price Floor Calculation.

A. Contrary To Bell Atlantic's Claim, AT&T's Recommended Approach Is Not "A Form Of 'Rate Element Imputation.'"

In an effort to persuade the Department to reject AT&T's recommended approach for applying the Department's price floor requirements, Bell Atlantic seeks to characterize the AT&T approach as "a form of 'rate element imputation,' a methodology that the Department previously rejected in this docket" BA Initial Brief, p. 5. Contrary to Bell Atlantic's claims, however, the rate element imputation that the Department rejected bears no resemblance to the *service*-based imputation that AT&T recommends here.

It is important here to explain the distinction between a rate element and a service specific imputation approach. A rate element approach has traditionally referred to an imputation requirement in which individual rate elements, which can not be purchased separately, but which are the pricing components of a standalone service, must each pass an imputation test. For example, BA-MA's MTS tariff, contains individual rate elements

for initial and overtime time of day periods (e.g., initial and overtime day, evening and night/weekend periods) further delineated by mileage bands (e.g., initial day period 0-10 mi. for Schedule 2) and per minute and per message rates (e.g., message and peak/off-peak per minute for).⁽¹⁾ Although none of these rate elements can be purchased separately from an existing BA tariff, a rate element imputation approach would require that each rate element or some combination of rate elements pass an imputation test.

Such a rate element approach was illustrated in the imputation standard offered by Bell Atlantic in which "each rate element or tariffed charge constitutes a separate service." D.P.U. 94-185 (August 29, 1996 ("Local Competition Order") at 18, quoting NYNEX exhibit.

Bell Atlantic proposed a separate price floor for the per message rate and a separate price floor for the per minute rate.⁽²⁾ The Department rejected this approach because "certain rate elements can *only* be purchased collectively." *Id.* at 29 (emphasis added). For example, it is not possible to buy the first minute of toll service without also incurring the message charge to make the call in the first place.

A service specific imputation approach ignores individual rate elements within a service and requires that the service as a whole pass an imputation test. Thus, AT&T recommends, that separate *services e.g., MTS* that can be bought *individually*, not *rate elements be subject to an imputation test*. Indeed, DPU 94-50 provides useful guidance for resolving the issue of how to calculate a price floor for offerings that combine services. The Department stated:

However, we are persuaded by the arguments of AT&T and MCI that it is no longer appropriate to base this differential [the differential between toll and access] on the average access rate and the average toll rate, as was done in the transition process. *Basing the toll-access link on average rates is inappropriate in this increasingly competitive market because NYNEX could then price anticompetitively for specific customers and/or services while still maintaining the proper differential on average*. Accordingly, NYNEX shall be required to comply with the price floor described above on a service-by-service basis.

Id. at 29 (emphasis added).⁽³⁾ Clearly, the principle that the Department was seeking to establish was one that prevented Bell Atlantic from combining services for the calculation of price floors in such a way that it could price anticompetitively for one service in a bundled offering while maintaining a price for the bundle that appears to meet the price floor requirement on average.

B. The Testimony of Bell Atlantic's Own Witness, Quoted in Its Initial Brief, Illustrates Why Bell Atlantic Should Not Be Allowed To Combine Its Toll And Non-toll Services For Purposes Of A Price Floor Calculation.

In a confusion of the basic principles, Bell Atlantic in its initial brief quotes its witness, Paula Brown, for the mistaken notion that AT&T's more service-specific approach (mischaracterized by Ms. Brown as a "rate element approach") would not solve the problem. In fact, Ms. Brown's example and reasoning precisely support AT&T's position that an aggregated approach permits Bell Atlantic to price anticompetitively for certain component services in the bundled offering, while appearing to satisfy the price floor requirement overall. Her language is worth repeating:

[T]he concept of developing a price floor for each component of a service, establishing a set of rates that equal or exceed the price floor, and then combining into one rate, makes no sense. For example, as Mr. Salvatore points out, Baystate Metropolitan service includes local calling, toll calling, and calling card services. let's suppose that the price of the service as a whole exceeded the price floor, but the individual local calling component did not exceed the price floor if considered as a separate rate element. The solution to the problem would be very simple, BA-MA could increase the price of the local component and decrease the price of other components.

For the reasons well articulated by Ms. Brown, the Department should reject Bell Atlantic's aggregate approach to calculating price floors.

C. Bell Atlantic Is Wrong When It Claims That It Has Done In Its Compliance Filing What AT&T Recommends It Should Do.

On pages 7 and 8 of its Initial Brief, Bell Atlantic correctly notes that AT&T recommended as one alternative approach that Bell Atlantic be required "to demonstrate that the total revenue generated by the packaged offering equals or exceeds the sum of the price of the 'relevant wholesale rate' plus the marginal costs of related overhead for all services contained within the package." Bell Atlantic is incorrect, however, when it then states that "[t]his is precisely what BA-MA has done in the Compliance Filing". *Id.*, p. 8. In fact, Bell Atlantic failed to comply with this alternative method, because it failed to identify the "relevant wholesale rate" for certain services within the bundled offering, in particular, for the local exchange service.

Bell Atlantic implicitly made the extraordinary assumption that local exchange service is not a service for which competitors require an input. As a result, rather than imputing the relevant wholesale rate for the inputs competitors require to offer local exchange service as it is required to do, it simply used (what it claims is) its "marginal cost."⁽⁴⁾ *See, e.g.*, BA Exh. 3 (Exhibit, Page 2 of 3, lines 3-6); *see also*, Tr. 9/15/99 (Brown), p. 84, lines 12-13. Were Bell Atlantic to use the TELRIC rates for providing local service, rather than its so-called marginal cost, many of its bundled offerings that include local exchange service may not pass the price floor test.

II. Contrary To Bell Atlantic's Claims, Use Of Separated Data Is Wrong.

Notwithstanding Department precedent rejecting separated cost data on the ground that it does not accurately measure intrastate costs (*Consolidated Arbitrations*, Phase 2, December 3, 1996) and notwithstanding the statements of its own expert economist that separated data do not measure economic costs (Tr. 9/20/99, p. 150, lines 21-23) and assign a component of costs arbitrarily (*id.*, p. 151, lines 6-7), Bell Atlantic takes the extraordinary position in its initial brief that it is AT&T's burden to prove that separated cost data are not appropriate.⁽⁵⁾ Bell Atlantic apparently contends that it is AT&T's burden to disprove the appropriateness of separated cost data simply because one of its witnesses states that "[i]t's not a simple thing" and gives an example of the difficulty, and the other states that "it would be nearly impossible[.]" BA Initial Brief, p. 9.

The fact is that Bell Atlantic must have affirmative proof to demonstrate that its proposed method for determining the amount of "marginal cost of related overhead" is accurate. It is not sufficient to simply contend that it is difficult to make such a determination and that other parties have not done it. This is especially true here, where (1) Bell Atlantic witnesses admit in this record that the method that Bell Atlantic uses (separations) is neither accurate nor economically rational, and (2) the issue is one that the Department has explicitly addressed and one on which it has made a specific factual finding. In *Consolidated Arbitrations*, D.P.U. 96-73/74, 96-75, 96-80/81, 96-83, 96-94 (Phase 2) (December 3, 1996), the Department stated:

As noted by AT&T and Sprint, the purpose of this proceeding [is] to look at the *actual* expenses incurred by NYNEX and to determine which of those expenses would be avoided if it were a wholesale company. We are creating a ratio, not determining a revenue requirement. Just as in the case of advertising, *we do not seek to determine which expenses are allowable in retail rates. The jurisdictional distribution of those costs, whether based on an arbitrary interstate/intrastate separation process or, indeed, our own intrastate ratemaking methodology, is not relevant.*

Id. at 33 (emphasis added).

Moreover, the Department has recognized that the separated data have an inherent bias that will tend to understate the amount of marginal costs related to increases (or decreases) in intrastate services. The Department stated:

In addition, we agree that to base the avoided cost determination on the separations process would be to impute *a policy of shifting avoided costs between jurisdictions, in the manner historically used to shift local costs to the long distance jurisdiction.*

Id. (emphasis added).

Given the lack of any affirmative evidence that Bell Atlantic has presented demonstrating that its method accurately measures marginal overhead cost of intrastate services, its own witnesses statements to the contrary, and unrebutted statements of AT&T witnesses to the contrary, there is not substantial evidence on this record, as a matter of law, to support a Department decision approving Bell Atlantic's proposal to use separated data. Moreover, it would be a violation of the reasoned consistency doctrine for the Department to approve Bell Atlantic's proposal to use separated data, given Department precedent finding that separated data do not accurately measure real, economic costs, without either substantial evidence or sound and well articulated reasons. The Department is not required, of course, to adhere forever to its prior decisions. To the contrary, the Department has substantial flexibility to reconsider existing regulatory policy in light of changed circumstances. *Boston Gas Co. v. Department of Public Utilities*, 367 Mass. 92, 104 (1975). The Department is constrained, however, to demonstrate a reasoned consistency in its decisions. As the Supreme Judicial Court has stated:

A party to a proceeding before a regulatory agency such as the Department has a right to expect and obtain reasoned consistency in the agency's decisions. This does not mean that every decision of the Department in a particular proceeding becomes irreversible in the manner of judicial decision constituting *res judicata*, but neither does it mean that the same issue arising as to the same party is subject to decision according to the whim or caprice of the Department every time it is presented.

Id. See also, *Massachusetts Automobile Rating and Accident Prevention Bureau v. Commissioner of Insurance*, 401 Mass. 282, 287-288 (1987). On the basis of the evidence in this record regarding the (lack of) accuracy and rationality of separated data for purposes of measuring economic costs, the Department cannot reverse its prior decision without violating the reasoned consistency doctrine.

III. Bell Atlantic's Complaints About Use Of The Resale Discount Are Not Valid.

In Section II.D. of its initial brief (pp. 10-12), Bell Atlantic attacks AT&T's recommendation that "the Department 'should adopt a retail overhead factor consistent with BA-MA's resale discount rate.'" (6) The basis for Bell Atlantic's attack is its contention that using the resale discount includes costs that do not vary with changes in output of toll service. In particular Bell Atlantic claims that use of the resale discount is inappropriate because it (a) includes "fixed" costs and (b) includes costs related to non-toll services, *e.g.*, local services. BA Initial Brief, p. 10. Bell Atlantic is wrong on both counts for the reasons set forth below.

A. The Allegedly "Fixed" Costs In The Resale Discount Are Long Run Variable Costs.

The resale discount includes long run variable costs, which will increase or decrease with changes in the size of Bell Atlantic's retail operations. All of these type of costs are ignored in Bell Atlantic's calculation of the 14.12% retail overhead factor. For example, as AT&T pointed out in its initial brief (pp. 22-23), although Bell Atlantic assumed a decline in worker salaries and direct expenses if retail outputs were to decline, it assumed that Bell Atlantic would do nothing to reduce its expenses for the buildings in which they work, the equipment that they use, the furniture in their offices, and the salaries of the human resources and accounting staff necessary to support them. See, Tr. 9/15/99, pp. 53-57. See also, ATT RR #1. Bell Atlantic also ignored the likelihood that a decline in the number of customers would mean a decline in operator services and all of the expenses associated with supporting that workforce. See, Tr. 9/15/99, p. 58.

The assumptions that Bell Atlantic used to develop its retail cost factor excludes these type of long run variable costs that are included in the resale discount factor because of the way the resale discount factor is calculated. Indeed, if Bell Atlantic had implemented the

principles espoused by its own expert economist, it would have included expenses related to buildings, land, equipment, support staff and the like. Dr. Taylor's testimony makes clear that such expenses vary over the long run and must be included:

A long-run cost study, on the other hand, says take all the time you need to readjust any existing contracts or equipment or anything like that that's in place today and what is the effect on cost in that circumstance. You could increase switching capacity or increase trunking capacity, take those costs into account; that would be a long-run cost study. And that is the cost standard that we tend to use for price floors.

Tr. 9/20/99 (Taylor), p. 138.

Moreover, the Department should not be misled by Bell Atlantic's constant focus on "the president's desk" as the quintessential fixed cost.⁽⁷⁾ See, BA Initial Brief, p. 12. As AT&T noted in its initial brief, such argument confuses the fact that the *type* of expense will continue with an (unsupported) assumption that the *level* of expense will continue. Bell Atlantic sets up a straw man here. While Bell Atlantic may continue to have one president (and a president's desk) if retail operations were to decline, the costs in the Executive account (6711) include the salaries and expenses associated with numerous executive positions and responsibilities. It is not hard to imagine an entire cadre of executive vice presidents at a firm like Bell Atlantic. If the size and scale of Bell Atlantic's retail operations were to decline, at least a few of them would be looking for other jobs.

Finally, if there were any doubt that the Department intended for Bell Atlantic to include costs that vary over the long term, such doubt is removed by the Department's express directive in D.P.U. 94-50 that the marginal cost of related overhead for toll service include advertising costs. See, *id.* at 250, n. 145. Bell Atlantic (then NYNEX) had long argued that advertising costs would not change with small changes in the amount of toll service provided and on that basis had argued that no advertising costs should be included in the "marginal cost of related overhead" for toll service. In directing that advertising costs be included, the Department was clearly recognizing that, over the long run, the amount of resources that Bell Atlantic would devote to advertising will change with the level of retail toll service provided.

B. Inclusion Of Non-Toll Retail Costs In The Calculation Of BA's Retail Overhead Factor Is A Non-Issue Because Bell Atlantic Actually Calculates Its Retail Overhead Factor (14.12%) Using Non-Toll Retail Costs And Because The Effect Of Such Inclusion Is Offset By The Inclusion Of Non-Toll Retail Revenues.

On page 10 of its initial brief, Bell Atlantic argues that "only those marginal costs that are caused by the provision of the retail portion of the toll services at issue" should be included. Referring to an assumption underlying the calculation of the resale discount factor, Bell Atlantic states that "[t]his assumption is completely inappropriate for determining the retailing costs of only a select few retail services." The problem with this criticism, however, is that it is immaterial to the dispute between Bell Atlantic and AT&T regarding the calculation of the retail overhead factor. The analyses of both companies include non-toll retail costs, but reach very different results: 14.12% vs. 24.99%.

There is another, more principled reason why the inclusion of non-toll retail costs is a non-issue: while it is true that the numerator of the fraction that produces both the 14.12% and the 24.99% includes the retail cost of non-toll services, the denominator of that fraction includes the revenues of non-toll services. See, Tr. 9/15/99, pp. 78-81. The effect, therefore, of including non-toll retail costs in the numerator is offset by the effect of including non-retail revenues in the denominator. Without knowing the relative proportions of toll and non-toll costs and toll and non-toll revenues, it is not possible to determine whether the net effect of including non-toll retail costs and revenues is positive or negative. It is entirely possible that the exclusion of non-toll costs and revenues from the calculation would *increase* the size of the factor.

As a practical matter, however, the Department does not need to worry about this issue because (despite Bell Atlantic's criticism of AT&T on this point), it did precisely the same thing.

Conclusion.

For the reasons stated above and in AT&T's initial brief regarding price floors, the Department should direct Bell Atlantic to recalculate its price floor analysis to:

perform a price floor calculation for each of the services in the bundled offering using TELRIC prices for the cost of local service elements that a competitor must purchase, or in the alternative perform a price floor calculation for each *toll* service included in its packaged offering in isolation of other services such as local;

calculate the marginal cost of related overhead using whole company (*i.e.*, unseparated data); and

include in the marginal cost of related indirect overhead expenses that vary with the level of output.

Moreover, until Bell Atlantic complete a proper price floor analysis in accordance with the above requirements, the Department should require Bell Atlantic immediately to satisfy a

price floor requirement that uses the 24.99% avoided cost discount as its marginal cost of related overhead.

AT&T COMMUNICATIONS OF NEW ENGLAND, INC.

Respectfully submitted,

Jeffrey F. Jones

Jay E. Gruber

Palmer & Dodge llp

One Beacon Street

Boston, MA 02108-3190

(617) 573-0100

Robert Aurigema

AT&T Communications of New England, Inc.

32 Avenue of the Americas, Room 2700

New York, NY 10013

(212) 387-5627

Dated: January 28, 2000

CERTIFICATE OF SERVICE

I hereby certify that I caused a true copy of the above document to be served upon the attorney of record for each other party on January 28, 2000

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CONCLUSION.¹¹

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1. 1 DT.E. MA No. 10, Rates and Charges, Part M, Section 1, Pages 29-32, Issued June 14, 1999, Effective July 14, 1999.

2. 2 Bell Atlantic did not recommend the rate element approach. See, Local Competition Order at 19 ("NYNEX argues that the Purchase Approach is the only viable method for establishing price floors" and providing specific criticisms of the rate element approach). Indeed, Bell Atlantic's principal purpose appears to have been to persuade the Department to adopt the "Purchase Approach" advocated by Bell Atlantic, the only other approach which Bell Atlantic had proposed. The Department, however, rejected both approaches. Interestingly, its grounds for rejecting the Purchase Approach advocated by Bell Atlantic are equally solid grounds for rejecting the approach advocated by Bell Atlantic now. See, discussion, *infra*.

3. 3 D.P.U. 94-50 p. 250.

4. 4 See, D.P.U. 94-50 (May 12, 1995) at 205-206 ("For those services where NYNEX controls an essential input for a competitor's offering of a competing service, in order to prevent anti-competitive pricing, the proper price floor for NYNEX's own rate element shall consist of the relevant wholesale rate that at least one competitor pays to NYNEX in order to offer the service, and NYNEX's marginal cost of related overhead. *For all other services, in order to prevent cross-subsidization, the proper price floor shall be the marginal cost, as reported in the company's most recent marginal cost study ("MCS"), MCS VI.*")

5. 5 See, *id.*, p. 9 ("[AT&T did not] present any evidence showing that the manner in which BA-MA used the separations information resulted in an assignment that did not provide a reasonable assignment of costs for purposes of price floor analysis.").

6. 6 AT&T's position is that the retail overhead factor should be calculated *in a manner that is consistent with* the methodology used for the resale discount. This requires at a minimum the inclusion of indirect costs that vary with a decrease in retail intrastate service, just as the resale discount includes costs that are avoided with the elimination of retail intrastate services. AT&T does not contend that Bell Atlantic must use the actual resale discount that was developed in the *Consolidated Arbitrations*, except as an interim measure until Bell Atlantic completes a properly performed calculation of the retail overhead factor.

7. 7 Although Bell Atlantic likes to use the president's desk as its favorite example of a "fixed" cost, in its calculation of the retail overhead factor, Bell Atlantic assumed that *the desks of **all** employees are fixed!* See, Tr. 9/15/99, pp. 53-57. See also, ATT RR #1.